No. 9909

In the United States Circuit Court of Appeals for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JACK L. WARNER, RESPONDENT

ON PETITION FOR REVIEW OF DECISION OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE PETITIONER

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OPINION BELOW

The opinion of the United States Board of Tax Appeals (R. 112–119) is reported at 42 B. T. A. 954.

JURISDICTION

This appeal involves gift taxes for the years 1932, 1933 and 1935 and is taken from a decision of the Board of Tax Appeals entered December 13, 1940. (R. 120.) The case is brought to this Court by petition for review filed March 6, 1941 (R. 121–126) pursuant to the provisions of Sections 1141–1142 of the Internal Revenue Code.

QUESTIONS PRESENTED

1. Taxpayer and his two brothers created reciprocal trusts, each dependent upon the other, and each cre-

ated in consideration of the other two. One trust was created by one brother for the benefit of taxpayer and his family, with provisions permitting the taxpayer, jointly with his attorney and the third brother, to revoke the trust and pay the proceeds to himself. The question is whether the distribution of the income from this trust to members of the taxpayer's family constituted a taxable gift by him in the year of payment.

2. The taxpayer transferred life insurance policies to a trust to hold until his death. The trustees were then to collect the proceeds and distribute *part of the principal and the income from the balance* to his wife and son, if living, and otherwise to specified remaindermen. The question is whether the payment of premiums constituted gifts of future interests under Section 504 (b) of the Revenue Act of 1932.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved herein are set forth in the Appendix, *infra,* pp. 35–37.

STATEMENT

The material facts, taken from the findings of the Board of Tax Appeals (R. 112–119) and from the exhibits contained in the record (R. 51–111), are as follows:

I

The taxpayer, Jack L. Warner, and Harry and Albert Warner, are brothers. They are the principal executives of Warner Brothers Pictures, Incorporated. The death of Harry's son in 1931, who had been expected to succeed the three brothers in repre-

senting the family interests in the corporation, caused the brothers to consider ways of insuring the financial security of themselves and their family. They decided to place about $6,000,000 invested in United States Government obligations in three trusts, and therefore consulted Stanleigh P. Friedman, who had been closely associated with them as counsel since 1912. (R. 13.) Friedman drew three trust instruments with the stated purposes (R. 114)—

> to secure a "maximum of revocability," to prevent any one brother from invading the corpus, to exclude any "possibility of reverter" to the grantor of the corpus of any trust, to prevent the grantor of a trust from receiving income of that trust, to prevent any one brother from dominating the affairs of the family of a deceased brother, and to minimize and avoid estate taxes. * * *

Counsel also suggested that the trusts be created before the gift tax provisions proposed in the 1932 Revenue Bill should become the law.

The three trusts were created on May 26, 1932, one by each brother, and each one transferred to the trust created by him $2,000,000 face amount of United States Government obligations. The trusts were to be substantially identical except as to beneficiaries. The trust created by Albert Warner provided that the income from one-half the corpus should be paid to the taxpayer, the income from one-fourth should be paid to Jack M. Warner, taxpayer's son, and the income from the other fourth should be paid to taxpayer's wife. It was so paid during the three taxable years here in-

volved. The trustees named were the three Warner brothers, Friedman and a bank. The power to revoke, alter and amend was vested exclusively in Harry Warner, Friedman and the taxpayer acting together, while the latter was alive, and the corpus upon revocation was to go to the taxpayer or his estate. (R. 114.)

For comparison, significant provisions of the three trusts set side by side may be summarized as follows (Ex. A, R. 51–81; Exs. C and D (see R. 33)):

Nominal Grantor	Albert Warner	Taxpayer	Harry Warner
1. Beneficiaries	Taxpayer and his family.	Harry Warner and his family.	Albert Warner and his family.
2. Persons having the joint power to revoke.	Taxpayer, Harry Warner and Friedman.	Albert and Harry Warner and Friedman.	Taxpayer, Albert Warner and Friedman.
3. Trustees	Taxpayer, Harry Warner, Friedman, and Central Hanover Bank.	Albert and Harry Warner, Friedman and Central Hanover Bank.	Taxpayer, Albert Warner, Friedman and Central Hanover Bank.
4. Recipient of corpus in event of revocation.	Taxpayer or his estate	Harry Warner or his estate.	Albert Warner or his estate.

The Board of Tax Appeals has found as a fact that (R. 115):

> It does not appear that any one of the Warners would have created a trust for the benefit of his brother's family had not the other two agreed at the same time to create similar trusts but, on the contrary, the creation of each was dependent upon and in consideration of the creation of the other two.

The Commissioner determined the deficiency against the taxpayer upon the theory that taxpayer was the settlor of the trust which made the payments to his

son and his former wife; that he and two persons without adverse interests could revoke the trusts; and that the trust was an incomplete gift and the payment of the income to the son and the wife constituted a gift taxable to the taxpayer. The taxpayer brought an action for redetermination of the deficiencies determined by the Commissioner (R. 4–20) and the Board of Tax Appeals found in his favor (R. 120). The Commissioner has appealed from the Board's decision. (R. 121–126.)

II

On May 26, 1935, taxpayer created an insurance trust (Ex. G, R. 81–111) with Albert Warner, Harry M. Warner, Friedman and the Central Hanover Bank as trustees, and deposited in it certain insurance policies on his life. The indenture provided that the trustees should set aside policies having a face value of $550,000 and hold them as a separate fund during his life; further that in case any income should be received from this trust fund during the period it should be applied to the payment of premiums, assessments and other charges upon any policies of insurance held in trust and the trustees should pay over any balance of income to Irma Warner, grantor's wife, and Jack M. Warner, his son, with remainders over in the event of their previous death. (R. 82–83.) Upon the death of the grantor, it was provided that the trustees should dispose of the principal of the trust fund as follows: (a) $400,000 to the taxpayer's wife if she should survive him, or if the wife should not survive the grantor but Jack should, then the trus-

tees were to add the money to the principal of the trust fund created for Jack's benefit. Finally, if Jack should not survive the grantor, the trustees were to distribute the proceeds to specified classes of remaindermen. (b) $150,000 from the principal to his son Jack, or if Jack should not survive the grantor, to specified classes of remaindermen. (R. 84–85.)

In his gift tax returns for the years 1932, 1933 and 1935, the taxpayer included as taxable gifts the amount which he paid as premiums on the life insurance policies which constituted the corpus of the insurance trust and no question has been raised here as to the inclusion. (R. 46.) However, in his gift tax returns, the taxpayer claimed exclusions in the amount of $5,000 for each beneficiary upon the ground that the gifts made were gifts of present interests. These exclusions were disallowed by the Commissioner, who made the following statement (R. 48–49):

> Two exclusions in the amount of $10,000, claimed with respect to the premiums paid on the life insurance policies placed in trust under the trust indenture dated May 26, 1932, are disallowed. As it appears that no payments will be made to the beneficiaries of the trust until your death, the gifts are considered to be gifts of future interests, against which no exclusions are allowable.
>
> *　　*　　*　　*　　*

Taxpayer filed his petition for redetermination before the Board of Tax Appeals, which decided that the payment of premiums did not constitute gifts of future interests and consequently that the exclusions

should be allowed under Section 504 (b) of the Revenue Act of 1932. (R. 118.) From this decision, the Commissioner has appealed. (R. 121–126.)

STATEMENT OF POINTS TO BE URGED

The statement of points, all of which are here relied upon, are set forth in full on pages 129–131 of the record. They may be roughly summarized as follows:

1. The Board of Tax Appeals erred in holding and deciding that the payments made from the trust established by Albert Warner to the son and wife of the taxpayer during the years 1932, 1933 and 1935, were not taxable in the year of their receipt as gifts made by the taxpayer.

2. The Board erred in failing to hold and decide that taxpayer was not entitled to the allowance of any exclusion with reference to gifts made for the insurance trust, in that all of the gifts made to the insurance trust were gifts of future interests as to which Section 504 (b) of the Revenue Act of 1932 permits no exclusion.

SUMMARY OF ARGUMENT

I

Our principal contention here focuses upon the trust created by Albert Warner under which the taxpayer, his wife and son were the beneficiaries and taxpayer was the recipient of the corpus in the event of revocation. Taxpayer, together with the third brother, Harry Warner, and his counsel, Stanleigh Friedman, had the joint power to revoke at any time. We submit

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that under the circumstances of this case taxpayer is the real grantor of the trust created by his brother, Albert Warner; further, that because he has retained the power to revoke, along with two other persons having no substantial adverse interest, he is subject to gift tax with respect to the income from the trust distributed to members of his family.

It is true that taxpayer was not the nominal grantor of the trust created by Albert Warner. However, the facts are that almost simultaneously he and his two brothers created trusts containing two million dollars each and substantially identical in form except as to the beneficiaries and the recipients of the corpus on revocation. By establishing reciprocal trusts, each of them succeeded in having a trust precisely identical with the one which he would have created for himself and family, but instead of establishing it directly it was arranged that the trust created by one brother should be for the benefit of the other two. The Board of Tax Appeals has found that the creation of each trust was dependent upon and in consideration of the other two. Under these circumstances, we submit that taxpayer must not be permitted both to keep his cake and eat it; the trust created by Albert Warner was clearly taxpayer's trust in every respect except for a pure formality.

Assuming that taxpayer is the real grantor of the Albert Warner trust, it is clear that he is subject to the gift tax upon the payment of income made to members of his family. We submit that this question is settled conclusively by literal interpretation of Sec-

tion 501 (c) of the Revenue Act of 1932. Furthermore, there are numerous analogous situations which compel the conclusion that taxpayer is subject to a gift tax. For example, the law has already been clearly settled that with respect to the gift of the corpus of the trust the transfer is not consummated so long as the donor continues to retain dominion and control over the property either in the form of a power of revocation, as here, or even of a power to modify and change the beneficiaries. The rationale is that taxation is based upon the *actual command* over the property taxed, and that while the power of revocation stood uncancelled, the gifts were inchoate and imperfect. If the law is so clearly settled with respect to the distribution of the trust *corpus* there is no reason why distribution of the trust *income* should not be subject to gift tax upon precisely the same principles.

As a further analogy supporting the proposition that the distribution of the income is subject to gift tax, the law is firmly settled that it would be taxable as income here to the taxpayer. Section 166 (1) of the Revenue Acts of 1932 and 1934 fully substantiates this fact. It is further established by the decisions of the Supreme Court, which enunciate the same principle applied in the corpus cases, namely, that taxation is primarily concerned with the actual command over the property taxed. The point stressed by the Supreme Court is that taxpayer in effect retained title to the income in the form of a power to stop payment at any time. Thus it seems clear that the income is taxable to the settlor so long as its disposition

is in reality still at his discretion, and from this it logically follows that when the income is actually disposed of, it should then be taxable as a gift from the taxpayer to the donee.

In reaching the conclusions above, we have treated this case as if taxpayer alone had the power to alter, amend and revoke the trust. This assumption is fully justified, despite the fact that taxpayer was to exercise it in conjunction with his counsel and his brother, Harry Warner. Neither of these parties had a substantial adverse interest in the disposition of the income or principal of the trust.

II

In computing his annual gifts to an insurance trust, taxpayer is not entitled to exclusions up to $5,000 for each beneficiary upon payments of the yearly premiums on the policies. Since the trustees could not collect and distribute the proceeds until taxpayer's death, it is clear that the premium payments constituted gifts of future interests under Section 504 (b) of the Revenue Act of 1932.

ARGUMENT

I

Taxpayer is subject to gift tax in each year with respect to the amounts of income paid to the beneficiaries of a trust of which he is the real as distinguished from the nominal grantor and which he has the power to alter, amend or revoke at any time during his life

Our principal contention in this case focuses upon a trust created by Albert Warner on May 26, 1932,

under the provisions of which the taxpayer, his wife and son were the beneficiaries and taxpayer was the recipient of the corpus in the event of revocation. Taxpayer, together with the third brother, Harry Warner, and his attorney, Stanleigh Friedman, had the joint power to revoke at any time. We submit that under the circumstances of this case, taxpayer is the real grantor of the trust created by his brother, Albert Warner; further that because he has retained the power to revoke, along with two other persons having no adverse interest, he is subject to gift tax with respect to the income from the trust distributed to members of his family.

A. Taxpayer is the real grantor of the trust created by his brother, Albert Warner

The facts are that almost simultaneously taxpayer and his two brothers created trusts containing two million dollars each, invested in United States Government obligations. The trusts were drafted with the acknowledged purpose of minimizing and avoiding estate taxes. (R. 114.)[1] They were substantially identical in form except as to the beneficiaries and the recipients of the corpus on revocation. The basic principle here was to achieve the desired objective by the circuitous method of creating reciprocal trusts. Each brother was to have a trust precisely identical with the one which he would have created for the benefit of himself and his family, but instead of establishing it directly it was arranged that Albert

[1] The purposes of the trust have been set forth at R. 114 and are recited in the Statement of Facts, *supra*.

Warner's trust should be for the benefit of the taxpayer, taxpayer's trust for the benefit of Harry, and Harry's trust for the benefit of Albert. Referring to this trust arrangement the Board of Tax Appeals made the following finding of fact (R. 115):

> It does not appear that any one of the Warners would have created a trust for the benefit of his brother's family had not the other two agreed at the same time to create similar trusts but, on the contrary, the creation of each was dependent upon and in consideration of the creation of the other two.

Under these circumstances, we submit that taxpayer must not be permitted both to keep his cake and eat it. The trust created by Albert Warner was clearly his trust in every respect except for a formality, namely, that Albert had established it in consideration of the creation of an equal and identical trust for his benefit.

The decisions amply justify the conclusion that the Albert Warner trust should be treated as taxpayer's trust. An almost identical situation arose in the case of *Lehman* v. *Comissioner,* 109 F. (2d) 99 (C. C. A. 2d), in which the decedent-taxpayer agreed to transfer an interest in bonds and stocks in trust for his brother Allan and his issue in consideration of Allan's transferring an equal share in trust for the decedent and his issue. Under the two trusts set up by the decedent, Allan was given the power to withdraw $75,000 and similarly the decedent had the power to withdraw the same amount from Allan's trusts. For purposes of assessing the estate tax on the decedent's estate,

the Commissioner determined that the decedent's right to withdraw $75,000 in the case of two trusts rendered $150,000 of the trust includible in his gross estate. The court pointed out that the present case was in substance the same as if the taxpayer had transferred his share of the property to trustees for his own life and had reserved the power to withdraw $150,000 from the principal, and pointed out further (p. 100):

> The fact that the trusts were reciprocated or 'crossed' is a trifle, quite lacking in practical or legal significance. In re Perry's Estate, 111 N. J. Eq. 176, 162 A. 146. The law searches out the reality and is not concerned with the form. See Matter of Orvis' Estate, 223 N. Y. 1, 8, 119 N. E. 88, 3 A. L. R. 1636.

The Court further said, at page 100:

> While section 302 (d) speaks of a decedent having made a transfer of property with enjoyment subject to change by exercise of power to alter, amend or revoke in the decedent, it clearly covers a case where the decedent by paying a quid pro quo has caused another to make a transfer of property with enjoyment subject to change by exercise of such power by the decedent. See 52 Harvard Law Review 1015. 'A person who furnishes the consideration for the creation of a trust is the settlor, even though in form the trust is created by another.' Scott on Trusts, section 156.3.

See also *Jackson* v. *Commissioner,* 64 F. (2d) 359 (C. C. A. 4); *Whiteley* v. *Commissioner,* 120 F. (2d) 782 (C. C. A. 3).

In addition to the *Lehman* case, which is squarely in point, there are analogous decisions by the Supreme Court which establish that the substance of this transaction must be emphasized above its form. For example, in *Chase Nat. Bank* v. *United States,* 278 U. S. 327, the Supreme Court held that the proceeds of certain insurance policies on decedent's life, respecting which the insured reserved the right to change the beneficiary and paid the premiums, were includible in the decedent's gross estate for estate tax purposes. The beneficiaries' interests in the policies were not transferred to them from the decedent but from the insurer and hence there was nothing to which a transferor privilege tax could apply, but the Supreme Court pointed out that the word "transfer" in the statute could not be construed in such a restricted sense, saying (p. 337, 338):

> It must, we think, at least include the transfer of property procured through expenditures by the decedent with the purpose, effected at his death, of having it pass to another. Sec. 402 (c) taxes transfers made in contemplation of death. It would not, we assume, be seriously argued that its provisions could be evaded by the purchase by a decedent from a third person of property, a savings bank book, for example, and its delivery by the seller directly to the intended beneficiary on the purchaser's death, * * *.
> * * * We think the power to tax the privilege of transfer at death cannot be controlled by the mere choice of the formalities which may attend the donor's bestowal of benefits upon an-

> other at death, or of the particular methods by which his purpose is effected, * * *.[2]

By the same token the fact that the taxpayer's family received income from Albert's trust rather than from his own should not affect the taxability of the transfer since the trusts were set up on a three-way reciprocal basis.

The same principle is demonstrated by *Helvering* v. *LeGierse,* 312 U. S. 531, in which the Court was faced with the question whether certain "insurance proceeds" should be included in the decedent's gross estate. On preliminary examination, the proceeds appeared clearly to be proceeds from an insurance policy just as the income was from Albert Warner's trust, but the Court took into consideration the fact that decedent had simultaneosuly taken out an annuity contract. Under these circumstances, it decided that there was no insurance risk, since the insurance policy would not have been issued without the annuity contract, and the risk involved in decedent's early death was compensated by an aliquot reduction in annuity liability. Thus, it is established that in various branches of tax law the Supreme Court has stressed the importance of examining the substance of the transaction as distinguished from the single item upon which the tax is based.

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[2] This construction of the "transfer" referred to under the estate tax law is equally applicable to gift tax cases because the two taxes are *in pari material* and subject to the same construction. *Estate of Sanford* v. *Commissioner*, 308 U. S. 39.

B. If the taxpayer is the real grantor of the Albert Warner trust, he is subject to a gift tax upon the payments of income made to the members of his family

In considering the question of the liability of the taxpayer for gift taxes upon payments of income made from the Albert Warner trust to members of the taxpayer's family, Section 501 (c) of the Revenue Act of 1932 (appendix, *infra*) is applicable to the first two of the three years' income, i. e., the years 1932 and 1933. The provision of Section 501 (a) is that a tax shall be imposed "upon the transfer by any individual * * * of property by gift, * * *." Referring to this tax, subsection (c) provides as follows:

> The tax shall not apply to a transfer of property in trust where the power to revest in the donor title to such property is vested in the donor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of such property or the income therefrom, but the relinquishment or termination of such power (other than by the donor's death) shall be considered to be a transfer by the donor by gift of the property subject to such power, and any payment of the income therefrom to a beneficiary other than the donor shall be considered to be a transfer by the donor of such income by gift.

It is true that subsection (c), above, was repealed by Section 511 of the Revenue Act of 1934, so for the year 1935 (which is also involved here) there is no statute which covers expressly the taxing of gifts where the donor has retained the power to revoke. Nevertheless, precisely the same rule still applies, for

it is definitely settled that subsection (c) was repealed solely because the decision by the Supreme Court in *Burnet* v. *Guggenheim,* 288 U. S. 280, was deemed to cover the point without statutory direction. This is established by the committee reports, and further verified by the Supreme Court in *Estate of Sanford* v. *Commissioner, supra,* where the Court said (p. 45, in fn. 1):

> Section 501 (c) of the 1932 Act added a new provision that transfers in trust, with power of revocation in the donor, should be taxed on relinquishment of the power. This was repealed by Sec. 511 of the Act of 1934, 48 Stat. 680, because *Burnet* v. *Guggenheim,* 288 U. S. 280, had declared that such was the law without specific legislation. H. R. No. 704, 73d Cong., 2d Sess., p. 40; Sen. Rep. No. 558, 73d Cong., 2d Sess., p. 50.

See also *Hesslein* v. *Hoey,* 91 F. (2d) 954, (C. C. A. 2d), certiorari denied, 302 U. S. 756.

Section 501 (c), set forth above, raises two fundamental questions. The first is whether taxpayer's power to alter, amend and revoke the trust jointly with his brother Harry Warner and his counsel Friedman (see R. 73–75, 114), is being exercised "in conjunction with any person not having a substantial adverse interest in the disposition of such property or the income therefrom, * * *." This question will be separately considered later in this brief. (C. infra). For the purposes of the succeeding discussion we shall make the assumption that Harry Warner and Friedman do not have adverse interests, and shall therefore

treat the case as if the taxpayer might exercise the power to alter, amend, and revoke the trust alone.

(1) Upon this premise it seems clear that the payment of income to the taxpayer's wife and child from the trust in the taxable years constitutes a gift of income in those years. We submit that this question is settled conclusively by the language of Section 501 (c). As pointed out by the dissenting Board Member (R. 118–119; see also dissent in *Estate of Mead* v. *Commissioner,* 41 B. T. A. 424, at p. 429), that section provides:

> The [gift] tax shall not apply to a transfer of property in trust where the power to revest in the donor title to such property is vested in the donor * * * but * * * any payment of the income therefrom to a beneficiary other than the donor shall be considered to be a transfer by the donor of such income by gift.

Here the facts are that the donor retained the power to revest title to the property, and the payments of income involved were to beneficiaries other than himself—all in accordance with the statutory provision, above. The case therefore fits perfectly within the literal language of the statute. The Committee Reports under the Revenue Bill of 1932 further illustrate this fact. H. Rep. No. 708, 72d Cong., 1st Sess., p. 28, 1939–1 Cum. Bull. (Part 2) 457, 477, referring to Section 501 of the bill imposing the gift tax stated:

> * * * where A creates a revocable trust naming B as beneficiary, a gift to B of the corpus is effected when A relinquishes the power to revoke or the power is otherwise terminated in B's favor (the income payments to B in the

> interim being gifts from A in the calendar years when received).

This position has been taken consistently by the Commissioner since the Revenue Act of 1924. See I. T. 2145, IV–1 Cum. Bull. 43 (1925). It is also in accordance with the Regulations applicable during 1932–1936. Regulations 79, 1933 and 1936 editions, Article 3.

(2) Furthermore, although there are no cases precisely in point there are numerous analogous situations which compel the conclusion that taxpayer is subject to a gift tax. For example, the law has already been clearly settled that with respect to the gift of the corpus of the trust a transfer is not consummated so long as a donor retains *dominion* and *control* over the property, either in the form of a power of revocation or even a power to modify and change the beneficiaries. In *Burnet* v. *Guggenheim,* 288 U. S. 280, the Court held that where trusts were created in 1917, a settlor reserving the power to modify, alter or revoke and relinquishing it in 1925 was subject to the gift tax under the Revenue Act of 1924. The Court pointed out that (pp. 283–284):

> "Taxation is not so much concerned with the refinements of title as it is with the actual command over the property taxed—the actual benefit for which the tax is paid." *Corliss* v. *Bowers,* 281 U. S. 376, 378. Cf. *Chase National Bank* v. *United States,* 278 U. S. 327; *Saltonstall* v. *Saltonstall,* 276 U. S. 260; * * *. While the powers of revocation stood uncanceled in the deeds, the gifts, from the point

> of view of substance, were inchoate and imperfect. By concession there would have been no gift in any aspect if the donor had attempted to attain the same result by the mere delivery of the securities into the hands of the donees. A power of revocation accompanying delivery would have made the gift a nullity. * * * By the execution of deeds and the creation of the trusts, the settlor did indeed succeed in divesting himself of title and transferring it to others * * *, but the substance of his dominion was the same as if these forms had been omitted. * * *

And the Court further said (p. 286):

> The statute is not aimed at every transfer of the legal title without consideration. Such a transfer there would be if the trustees were to hold for the use of the grantor. It is aimed at transfers of the title that have the quality of a gift, and a gift is not consummate until put beyond recall.

The Court then pointed out (pp. 286–287) that the gift and estate tax provisions are *in pari materia* and that the construction adopted in the estate tax cases was equally applicable to the gift tax.

c) The principles set forth in *Burnet* v. *Guggenheim, supra,* were further amplified by the Supreme Court in *Estate of Sanford* v. *Commissioner,* 308 U. S. 39. There it was held that a gift in trust with a reservation by the donor of the power to alter the disposition of the property in any way not beneficial to himself was incomplete and was not subject to gift taxes until he renounced it. See also *Rasquin* v. *Humphreys,* 308

U. S. 54. Besides applying *Burnet* v. *Guggenheim,* the Supreme Court rested its decision (p. 48) upon the proposition that the gift tax supplemented the estate tax and that *Porter* v. *Commissioner,* 288 U. S. 436, had held that a trust reserving the power to change the beneficiary was taxable as part of the donor's gross estate.

Now, if the law is so clearly settled with respect to the distribution of the trust corpus the next question is why distribution of the trust income should not also be subject to gift tax upon precisely the same principles.[3] Control of the income through the power of revocation should be the governing consideration irrespective of the location of technical title. The Board of Tax Appeals concluded to the contrary (R.

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[3] Commenting generally upon the question, Roswell Magill has said (The Federal Gift Tax, 40 Col. L. Rev. 772, 875):

> A related problem is the gift tax liability with respect to the annual payments of income to the beneficiaries of a trust, subject to such a power to alter or revoke that its creation does not subject the settlor to a gift tax. Granted that the gift of corpus is incomplete, so that the property must be regarded as still part of the settlor's estate, each transfer of income to the beneficiary appears to be a completed gift. Hence the donor should be taxable thereon. A recent Board decision takes a contrary view, however, four members dissenting. [*Giles W. Mead*, 41 B. T. A. 424 (1940).] The reasoning of the majority—that until the donor alters or amends the trust, the beneficiary is the owner of the income—seems inadequate in the light of the analysis adopted in the *Sanford* case. Here are completed transfers being made to another during the donor's life out of property which admittedly will be part of his estate when he dies, yet no gift tax is imposed. It is submitted that it is unsafe to rely upon the Board's decision until it is affirmed, or until other similar cases are decided.

117), relying upon the case of *Estate of Mead* v. *Commissioner,* 41 B. T. A. 424, which was appealed but later settled and the appeal dismissed. The *Mead* opinion states that the rationale of the decisions applicable to gifts of corpus is not controlling because the indenture entitled the beneficiary to the net income of the property held in trust during her lifetime or until the donor exercised his power of modification. The Board further held that the beneficiary became the owner of an equitable interest in the corpus of the trust property, subject to being divested by the happening of a subsequent event, and continued, saying (p. 428):

> By virtue of this interest in the corpus of the trust she was entitled to enforce the trust, to have a breach of trust enjoined, and to require the net income to be paid over to her by the trustee. The interest was present property, alienable like any other in the absence of a valid restraint upon alienation * * *. Since the net income was currently distributable to her, it became her property within the meaning of the taxing statutes at the time of its receipt by the trustees. * * *

But the foregoing presents no logical distinction from the cases dealing with gifts of the corpus of a trust. It may be true that the income beneficiary became an owner of an equitable interest in the corpus subject to being divested, but this is precisely the status of beneficiaries who are donees of the corpus. See *Burnet* v. *Guggenheim, supra,* p. 284. In situations like the *Sanford* case and *Burnet* v. *Guggenheim,*

just as in the *Mead* case, the beneficiaries of the corpus would be entitled to enforce the trust and to have a breach of trust enjoined and further to have the corpus paid to them at the specified time if the power to revoke had not been exercised. Their interest also (like the right to income) would be alienable and assignable, but subject to divestment.

It may also be true, as stated by the Board of Tax Appeals in the *Mead* case that (p. 429):

> * * * when net income from trust property accrued there arose an obligation of the trustee to distribute such income to the beneficiary of the trust. The distribution was in satisfaction of that obligation and not a gift of income * * *

But this merely evades our basic contention here. The facts are that even if an obligation arose when the net income accrued, the date of its creation *as an obligation* marks the occasion of the gift from the taxpayer to the beneficiaries. Only when the taxpayer has lost the power to revoke the beneficiaries' right to income can it be said that the gift is completed and taxable to the donor. Until that time he still retained actual command over its distribution, the point which the Court emphasized in *Burnet* v. *Guggenheim, supra* (see p. 283).[4]

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[4] The language of *In re Hoyt's Estate*, 149 N. Y. Supp. 91 (Surrogate's Ct., N. Y. Cty.) expressed our position with great clarity. There it was held that where a donor executes a trust deed conveying certain real estate, the income to be paid to her son for life, with remainders over, but reserves absolute power to amend or revoke the deed, the conveyance was upon the donor's death sub-

The *Guggenheim* case in two separate dicta has in fact stated that there is no logical justification for applying the gift tax to the corpus and not to the income. At p. 284 the Supreme Court said:

> As to the principal of the trusts and as to income to accrue thereafter, the gifts were formal and unreal. They acquired substance and reality for the first time in July, 1925, when the deeds became absolute through the cancellation of the power.

And again at pp. 289–290, the Court concluded as follows:

> The argument for the respondent, if pressed to the limit of its logic would carry him even further than he has claimed the right to go. If his position is sound that a power to revoke does not postpone for the purpose of taxation the consummation of the gift, then the income of these trusts is exempt from the tax as fully as the principal. What passed to the beneficiaries was the same in either case, an interest inchoate and contingent till rendered absolute and consummate through receipt or accrual before the act of revocation. Congress did not mean that recurring instalments of the income,

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ject to a transfer tax. The portion of the opinion which bears out our contention appears in the following quotation (p. 93):

> When the cestui que trust received an installment of the income of the trust fund, that constituted a valid gift of the installment, but each installment might be the last, as the donor might revoke the deed before the new installment became due. It was not therefore until the death of the donor that the gift in any aspect became absolute, and that the cestui que trust became irrevocably entitled to the income of the trust property.

> payable under a revocable conveyance which had been made by a settlor before the passage of this statute, should be exempt, when collected, from the burden of the tax.

In other words, the trustees' obligation to distribute and the beneficiary's right to receive each installment of income were always subject to a power of revocation until the income had become vested and payable. Likewise here, in view of the fact that the taxpayer, his brother and counsel could exercise their power of revocation "at any time" (R. 73), it seems clear that the beneficiaries' right to any year's income could be cut off up to the date when it became vested and properly "payable and distributable by the trustees" under the provisions of the indenture [5] (see R. 75). Since it is self-evident that 1932, 1933, and 1935 income could under no circumstances constitute an obligation to the beneficiaries before its receipt by the Trustees, it logically follows that it must be taxable as a gift in those years.

(3) Further to support the proposition that the distribution of the income here is subject to *gift tax,* the law is settled that it would be taxable as *income* to the taxpayer. Section 166 (1) of the Revenue Acts of 1932 and 1934 fully substantiates this fact. It is further established by the decision of the Supreme

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[5] The indenture provides that the trustees shall pay over to the beneficiaries "the entire net annual income therefrom in each year" during their lives, etc. (R. 52, 53). We construe this provision to say that the income is payable at the end of the year, but not necessarily before that time. However, for the purposes of our argument, the question is not important to decide.

Court in *Corliss* v. *Bowers,* 281 U. S. 376. The basic principle there is the same as was later applied in the corpus cases, including *Burnet* v. *Guggenheim, supra* (see B. (2) above). In *Corliss* v. *Bowers,* the petitioner created a trust under which his wife has to receive the income for life, reserving to himself the power at any moment to abolish or change the trust at his will. The Court held that the income of the trust was taxable to the grantor for income tax purposes and said (pp. 377–378):

> But the net income for 1924 was paid over to the petitioner's wife and the petitioner's argument is that however it might have been in different circumstances the income never was his and he cannot be taxed for it. The legal estate was in the trustee and the equitable interest in the wife.
>
> But taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid. If a man directed his bank to pay over income as received to a servant or friend, until further orders, no one would doubt that he could be taxed upon the amounts so paid. It is answered that in that case he would have a title, whereas here he did not. But from the point of view of taxation there would be no difference. The title would merely mean a right to stop the payment before it took place. The same right existed here although it is not called a title but is called a power.

While the case relates to income tax, its application to transfers is obvious even without the reliance by

the Court on the "transfer" cases, including *Saltonstall* v. *Saltonstall,* 276 U. S. 260; *Chase Nat. Bank* v. *United States,* 278 U. S. 327, and *Reinecke* v. *Northern Tr. Co.,* 278 U. S. 339. As already noted, both lines of cases are the product of the same underlying theory. The basic principle of *Corliss* v. *Bowers,* is that while "actual command" over disposition of the income is retained, taxpayer cannot be deemed to have disposed of it. The income is therefore taxable to him and its disposition is in effect at his direction. From this it follows logically that when the income is actually disposed of, it should be taxable as a gift from the taxpayer to the donee.

Further in connection with the *Mead* case, it should be noted that the Board of Tax Appeals actually rested its decision in part upon the the issue whether the income of the trust would be taxable to the donor. But there the donor had retained only the power to change the beneficiaries (without naming herself), and the Board concluded (p. 429):

> It should be borne in mind that the trust involved herein is not a revocable trust of such a nature that the income therefrom would be taxable to the donor. *Knapp* v. *Hoey,* 104 Fed. (2d) 99; *Ellsworth B. Buck,* 41 B. T. A. 99. Since the income will not be considered for purposes of taxation as having been received by the donor of the trust, it would appear illogical to consider it as being the subject of a gift from the donor of the trust to the beneficiary.

Here, on the other hand, the taxpayer retained the power of *revocation,* so upon the Board's own

premises be would be taxable with the income of the trust, and therefore subject to a gift tax in the event of its distribution.[6]

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[6] Though we do not need to go so far in the case at bar, we call the Court's attention to the recent decisions establishing that even upon the facts in the *Mead* case (i. e., where the donor retained the power to change the beneficiaries, as distinguished from the power of revocation), the donor was properly taxable with the income of the trust. Since the *Mead* case was decided, *Buck* v. *Commissioner*, 41 B. T. A. 99, upon which the Board relied, has been reversed by the Circuit Court of Appeals for the Second Circuit, 120 F. (2d) 775. It is true that in the quoted opinion above, the Board also relied upon *Knapp* v. *Hoey*, 104 F. (2d) 99, but the facts are that the latter case was decided by the same Circuit Court of Appeals (for the Second Circuit) long before it decided *Commissioner* v. *Buck*. The *Buck* decision did not actually overrule *Knapp* v. *Hoey*, *supra*, but merely passed over it, pointing out that it was decisive as to the application of Sections 166 and 167, but did not raise the question of the application of Section 22 (a).

The rule now established is that even though there is no statute providing expressly for the taxability of the income to the settlor where he has retained the power to change his beneficiaries, nevertheless it is taxable to him under the broad definition of income (under Section 22 (a)). The underlying theory is that where the settlor retained the economic satisfactions of ownership *after* the creation of the trust as *before*, the Commissioner was justified in continuing to tax him upon its annual income. See also *Commissioner* v. *Brown*, 112 F. (2d) 800 (C. C. A. 3d). We earnestly request the Court to read the opinion of the Circuit Court of Appeals for the Second Circuit in the *Buck* case as an excellent summary of the effect of three recent decisions of the Supreme Court upon broadening the taxability of income to the settlor or donor. *Helvering* v. *Clifford*, 309 U. S. 331; *Helvering* v. *Horst*, 311 U. S. 112; and *Harrison* v. *Schaffner*, 312 U. S. 579. Under these circumstances, if the taxpayer here is liable to pay an income tax not only by reason of the express provisions of Section 166, but also under the broad definition of income of Section 22 (a), then it seems even more reasonable that the distribution of that income should constitute a transfer subject to the gift tax.

C. Taxpayer's counsel and brother do not have a substantial interest adverse to the taxpayer in exercising the power of revocation

A further question to be considered is whether taxpayer's power to revoke, jointly with his counsel Stanleigh Friedman and his brother Harry Warner, would be exercised in conjunction with persons having a substantial adverse interest, within the meaning of Section 504 (c). We submit that under the circumstances of this case neither the counsel nor Harry Warner represent substantial interests which are adverse to the taxpayer.

Our conclusion with respect to Friedman is readily justified. If taxpayer's counsel would not follow his wishes with respect to the exercise of such a power it would be difficult to find anyone whose interests would not be considered adverse. It appears from the record that Friedman did not participate in any way in the distribution of either the principal or income of the trust, and that he had been the personal counsel and adviser to the Warner brothers from 1912 to date. (R. 43.) There was thus no basis for claiming that Friedman would not be amenable to the taxpayer's wishes. The cases fully substantiate the proposition that under these circumstances counsel cannot be deemed to have a substantial adverse interest. See *Reinecke* v. *Smith*, 289 U. S. 172; *Morton* v. *Commissioner,* 109 F. (2d) 47 (C. C. A. 7th).

Similarly, it is impossible to say that Harry Warner had a substantial interest adverse to the taxpayer. In fact, we question whether he had any adverse interest at all. In this connection, it must be remembered

that here we are concerned with a gift tax solely upon the *income* of the trust, so the only question is whether Harry Warner's interest in the *income* of the trust might be adverse to a determination by taxpayer to exercise the power to alter, amend or revoke. Here the facts are that the income in the years involved had to be distributed pursuant to the terms of the trust instrument to the taxpayer, his wife and son—all of whom were then living; under these circumstances Harry Warner could actually never expect to receive any of the income and thus had no "interest" whatever in it. It therefore follows that Harry would have no *adverse interest* if the taxpayer chose to alter the terms of the indenture and change the distributees of the trust income.

Furthermore, even if it may be said that Harry Warner had an adverse interest in the distribution of the corpus, this interest was entirely contingent, upon three factors:[7] (1) the death of the taxpayer's son prior to the termination of the trust without issue living at that time, (2) upon his (Harry's) surviving at the termination of the trust, and (3) upon the non-existence of next of kin of taxpayer having superior rights at that time, e. g., taxpayer's children other than the son specifically mentioned. (R. 53–54; 55–56; 56–58; 58–60.) Even upon satisfaction of all of these conditions Harry would merely share as one of the persons who could take under the laws of New York

[7] There was also a provision that the taxpayer's son might direct payment of a part of the trust *res* to his (the son's) wife, by his Last Will and Testament.

if the taxpayer had died seized and possessed of the property. Thus it appears that Harry might stand to receive as much by inheritance, as one of the next of kin or a beneficiary under taxpayer's will, as he would by the terms of the trust instrument. Under these circumstances we submit that his adverse interest, if any, is obviously nominal and technical rather than substantial in fact, as the statute requires. See *Commissioner* v. *Caspersen,* 119 F. (2d) 94 (C. C. A. 3d), certiorari denied, October 13, 1941.

Finally, as a practical matter, in view of the close family tie-up and the general scheme of setting up three reciprocal trusts here taxpayer cannot say there was a substantial possibility that Harry Warner would refuse to cooperate. The facts are that Harry, Albert and taxpayer were all very rich and the whole purpose of simultaneously setting up three trusts of $2,000,000 each was to protect their own families. The purpose was understood by all three and they all appeared to have implicit confidence in each other. Together they were running the motion picture business bearing their name; in 1927 they had formed a personal holding company called Renraw, Inc., for the purpose of obtaining greater economic security in respect of their private fortunes; until his death in 1931 they all looked upon Lewis Warner, Harry's son, as the family representative and the one who might be expected to take care of their wives and children. (R. 38–43.) In other words, their personal as well as business relationship was close enough to attempt another joint

project, this time for the purpose of minimizing their personal tax liability.[8]

With this understanding of the relationship between the brothers, it seems clearly unreasonable to claim that Harry Warner has a substantial adverse interest. The question is a practical one and cannot be decided in a legal vacuum. *Fulham* v. *Commissioner,* 110 F. (2d) 916 (C. C. A. 1st). Here no one who is realistic can deny that the persons in whom the joint power of revocation was vested would respect the taxpayer's preference. The cases bear out the proposition that where the so-called adverse interest is subject to so many contingencies and further where there was a close family unit, such interest could not properly be deemed substantial as required by the statute. See *Fulham* v. *Commissioner, supra; Commissioner* v. *Caspersen, supra; Morton* v. *Commissioner, supra.*

II

Taxpayer's payment of premiums on insurance policies held in trust constituted gifts of future interests in property

As the Board of Tax Appeals has indicated (R. 117), the only other question remaining for deci-

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[8] It is true that taxpayer had no *direct* control over the trust of which Harry Warner's family was the beneficiary and of which he (the taxpayer) was the nominal grantor; there the persons having the power to revoke were Harry Warner or Albert Warner. However, the facts are that in the trust of which Harry Warner was the nominal grantor and Albert Warner's family were the beneficiaries (Albert having a joint power to revoke) the taxpayer could refuse to cooperate and in this way could exert a pressure on Albert Warner to prevent revocation of the trust for the benefit of Harry Warner.

sion is whether taxpayer is entitled to annual exclusions up to $5,000 for each beneficiary in computing his annual gift to an insurance trust resulting from payment of the annual premiums. Pursuant to the terms of the trust indenture, the trustees were to collect the proceeds at taxpayer's death and distribute a part to his son and his then wife if they survived, with remainders over (R. 84–85), and hold the balance, distributing the income to the same parties (R. 86–87, 118). The Board of Tax Appeals held that the payment of the premiums constituted gifts of present interests under Section 504 (b) of the Revenue Act of 1932, citing cases, and concluding as follows: "Contra *U. S.* v. *Ryerson,* — Fed. (2d) — (7/9/40)." Since the Board's decision the Supreme Court has affirmed the *Ryerson* case, *Ryerson* v. *United States,* 312 U. S. 405.

Section 504 (b) of the Revenue Act of 1932 provides that the first $5,000 of each gift other than gifts of future interests of property shall be excluded for the purposes of taxation. We submit that the gifts here involved are gifts of future interest and hence that no exclusions are allowable. This Court has already decided the identical question in favor of the Commissioner in *Commissioner* v. *Boeing,* on October 23, 1941, not yet reported, saying:

> Under the very recent decisions in *United States* v. *Pelzer,* 312 U. S. 399, and *Ryerson* v. *United States,* 312 U. S. 405, it is clear that the gifts in the case before us were of future interests so far, at least, as concerns the proceeds and the income from the proceeds of the policies

themselves. These mature only on the death of the trustor. * * *

Under these circumstances we submit that taxpayer is entitled to no exclusions in respect of the payment of premiums upon policies held in the insurance trust.

CONCLUSION

The decision of the Board of Tax Appeals is wrong and should be reversed.

Respectfully submitted,

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APPENDIX

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 501. IMPOSITION OF TAX.

(a) For the calendar year 1932 and each calendar year thereafter a tax, computed as provided in section 502, shall be imposed upon the transfer during such calendar year by any individual, resident or nonresident, of property by gift.

(b) The tax shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible; but, in the case of a nonresident not a citizen of the United States, shall apply to a transfer only if the property is situated within the United States. The tax shall not apply to a transfer made on or before the date of the enactment of this Act.

(c) The tax shall not apply to a transfer of property in trust where the power to revest in the donor title to such property is vested in the donor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of such property or the income therefrom, but the relinquishment or termination of such power (other than by the donor's death) shall be considered to be a transfer by the donor by gift of the property subject to such power, and any payment of the income therefrom to a beneficiary other than the donor shall be considered to be a transfer by the donor of such income by gift. (U. S. C., Title 26, Sec. 550.)

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SEC. 504. NET GIFTS.

(a) General Definition.—The term "net gifts" means the total amount of gifts made during the calendar year, less the deductions provided in section 505.

(b) Gifts Less Than $5,000.—In the case of gifts (other than of future interests in property) made to any person by the donor during the calendar year, the first $5,000 of such gifts to such person shall not, for the purposes of subsection (a), be included in the total amount of gifts made during such year. (U. S. C., Title 26, Sec. 553.)

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 511. GIFTS OF PROPERTY SUBJECT TO POWER.

Subsection (c) of section 501 of the Revenue Act of 1932 (relating to the inapplicability of gift tax in the case of the transfer of property in trust subject to the power of the donor to revest title in himself) is repealed. (U. S. C., Title 26, Sec. 550.)

Treasury Regulations 79 (1936 Ed.):

ART. 3. *Cessation of donor's dominion and control.*—The tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned upon ability to identify the donee at the time of the transfer. On the contrary, the tax is a primary and personal liability of the donor, is an excise upon his act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable.

As to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no

power to cause the beneficial title to be revested in himself, the gift is complete. But a transfer (in trust or otherwise), though passing both legal and beneficial title, is still in essence merely formal so long as there remains in the donor a power to cause the revesting of the beneficial title in himself, and the gift, from the standpoint of substance, remains incomplete during the existence of the power. A donor shall be considered as having the power to revest in himself the beneficial title to the property transferred if he has such power in conjunction with any person not having a substantial adverse interest in the disposition of the property or the income therefrom. A trustee, as such, is not a person having a substantial adverse interest in the disposition of the trust property or the income therefrom. The relinquishment or termination of the power, occurring otherwise than by the death of the donor (the statute being confined to transfers by living donors), is regarded as the event which completes the gift and causes the tax to apply.[1] The receipt of income or of other enjoyment of the transferred property by the transferee or by the beneficiary (other than by the donor himself) during the interim between the making of the formal transfer and the relinquishment or termination of the power operates to free such income or other enjoyment from the donor's power to receive it himself, and constitutes a gift of such income or of such other enjoyment taxable in the calendar year of its receipt.

If the donor contends that a power retained by him constitutes beneficial dominion and con-

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[1] So held in *Burnet* v. *Guggenheim* (288 U. S., 280, 53 S. Ct., 369) of a transfer in trust, made in 1917, with power in the donor to revoke, which power he relinquished in 1925, the relinquishment being treated a gift subject to the tax imposed by the gift tax title of the Revenue Act of 1924.

trol, and that by reason thereof the transfer is not in substance a gift, the transaction shall be disclosed in the return and evidence showing all relevant facts, including a copy of the instrument by which the transfer was made, should be submitted.

ART. 11. *Future interests in property.*—No part of the value of a gift of a future interest may be excluded in determining the total amount of gifts made during the calendar year. "Future interests" is a legal term, and includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commerce in use, possession, or enjoyment at some future date or time. * * *

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